



THE FUND IN 1995/96





THE ROLE OF THE FUND: FINANCING AND ITS LINK TO SURVEILLANCE

In the decades since the Fund was established under the Bretton Woods agreement in 1944, four major developments have altered fundamentally the global economic environment in which it operates: a system of fixed parities linked to gold has been replaced by much greater flexibility in exchange rates; the volume of private capital flows has increased greatly; the growth in trade and expanded capital flows have resulted in greater integration among countries but, at the same time, have also made countries more vulnerable to external shocks; and the membership of the Fund has become nearly universal. At its meeting in April 1995, the Interim Committee requested the Board to review in the changed global environment the evolving role of the Fund in carrying out its responsibility to avoid, or help to correct, maladjustments in countries' balance of payments, focusing on the relationship between Fund financial assistance and Fund surveillance over members' exchange rate policies. This review was held in August 1995.

Rationale for Fund Financing

In their discussion, Directors observed that generalized exchange rate flexibility and expanded private capital flows had influenced Fund financing in several ways. Although for many member countries the financing of current account imbalances had become easier, countries had become more vulnerable to shifts in market sentiment, as well as to the risk of an abrupt halt to market access. Even Fund members that had chosen a floating exchange rate regime had increased their reserve holdings over time and often had intervened in the market to influence their exchange rates. Industrial countries had made no recent use of Fund financing. For most members, however, the Fund's role as a possible source of temporary balance of payments financing in support of adjustment efforts remained important.

The Board agreed that the rationale for Fund financing was to reduce potential disruption associated

with policy adjustments or exogenous shocks, and that its effectiveness was closely linked to surveillance and conditionality. Private capital markets were not willing or were unable to provide financing in all instances; in addition, private capital flows were on occasion liable to sudden or arbitrary shifts. These could lead to balance of payments problems for countries, with possible spillover effects on other countries. In such circumstances, the Fund could supplement private financing and ensure that member countries undertook appropriate policies. Directors stressed that a key aim of surveillance was to lessen the likelihood and severity of balance of payments crises and to enhance private sector confidence. The combination of surveillance and conditional financing served to assure members that they would not be vulnerable to undue risks as they liberalized and opened up their economies.

The Mexican financial crisis in December 1994 had provided additional impetus to the efforts to strengthen surveillance, and several Directors emphasized that surveillance should focus more on the financial sector and on external debt management. Many Directors, however, noted that even with more effective surveillance, the Fund would still have had to commit substantial resources to assist Mexico. Nevertheless, the Board agreed that the scale of total financial support provided to Mexico was extraordinary and should not be seen as setting a precedent.

Directors reiterated that Fund financing should be temporary and extended under appropriate safeguards. Furthermore, the conditionality associated with Fund-supported programs should ensure that the payments imbalances would be corrected within a reasonable time and that the Fund would be repaid. Directors agreed that the practices and policies accompanying Fund financial assistance were appropriate and did not create incentives for members to pursue risky economic policies. Many Directors were concerned, however, that the financing extended in the case of Mexico could create a moral hazard from the viewpoint of

creditors, with potential risk for the future because investors might be encouraged to ignore or take insufficient note of the riskiness of their investments. These Directors emphasized that guaranteeing the value of the foreign currency—or other—liabilities of governments was not within the Fund's purview. However, some other Directors did not consider that the Fund's assistance to Mexico had created serious moral hazard.

Future Need for Fund Resources

In the context of the future need for Fund resources, Directors considered member countries in four groups.

- *Industrial countries.* These countries had made infrequent use of Fund resources—given their access to private financing—but their need remained a possibility, and many Directors emphasized that the Fund should maintain adequate liquidity for this reason. Directors observed, however, that the Fund's primary responsibility with respect to these countries was surveillance. In particular, stronger and more effective surveillance was important for industrial economies that were of systemic importance—peer pressure alone was insufficient. In this connection, they emphasized the importance of multilateral surveillance—including in the context of the Board's discussions on the World Economic Outlook—as a means of exercising effective surveillance over the economies and exchange rates of the industrial countries and ensuring that their policies took due account of the interests of the rest of the world. Directors noted that the industrial countries also had a strong interest in the ultimate aim of the Fund's multilateral surveillance, including the promotion of global noninflationary and sustainable growth.

- *Middle-income developing countries.* These countries were increasingly important in the world economy,

and effective surveillance would ensure continuation of the powerful economic performance of many of them. For these countries, Fund surveillance should attempt to identify and avert potential crises. If a crisis did occur, the Fund should be able to provide sufficient balance of payments support rapidly—under appropriate conditionality—to limit the fallout from the crisis.

- *Transition countries.* Most Directors expected that these countries would continue to require substantial Fund financing, together with technical assistance and surveillance. Given the structural adjustments needed in these countries, Directors agreed that Fund assistance might well be required for longer periods than usual in Fund-supported programs. Many Directors pointed out that an important objective of Fund surveillance and Fund involvement with these countries was to help prepare them to rely on normal capital flows, including private market financing.

- *Poorer developing countries.* Directors commented that financing from the multilateral development banks and donors was of paramount importance for these countries. They agreed that the Fund had a legitimate role in providing temporary concessional financing in support of efforts to correct balance of payments problems. They also agreed that the means to continue this vital function had to be ensured.

There was consensus in the Board that a crucial responsibility of the Fund was in providing balance of payments support, together with its surveillance role and technical assistance activities. In general, no major reshaping of the financing role of the Fund was seen to be necessary. In considering the maturity structure of the Fund's various financial facilities, many Directors commented on the importance of preserving the monetary character of the Fund.

